Internal Revenue Service

memorandum

CC:CIN
JEKagy:bsm

date: NOV 4 1991

to: Chief, Appeals Division
Cincinnati, Ohio
Attn: Clyde Foster

from: District Counsel
Cincinnati, Ohio

---

bject: [redacted]

Attached is a copy of an October 28, 1991, memorandum from Senior Technical Reviewer, Branch 1, Office of Assistant Chief Counsel (P&SI) regarding a TEFRA issue which was raised early last year with regard to the taxpayer noted above. As your reading of the memorandum will disclose, National Office proposes two alternatives for the treatment of the amount in question. Under the first alternative, the Service could make a computational adjustment that disallows the partnership item on the corporation's return without mailing an FPAA to the TMP or to the partner. The rationale utilized is that by deducting the amount, [redacted] did not treat the amount in a manner which was consistent with the treatment of the item by the partnership. Under the second alternative, the Service could mail an FPAA to the TMP proposing to adjust the amount in controversy as an additional contribution received by the partnership. Simultaneous with that mailing, a notice of deficiency could be mailed to [redacted] under section 6213 disallowing the disputed amount because the item is a partnership item. The attached memorandum attempts to explain the procedural ramifications involved with both alternatives.

Once you have had the opportunity to digest the attached memorandum, if you feel additional questions remain, or if you wish to discuss the potential settlement of your issue as it is affected by the earlier settlement of a similar action with

regard to [redacted], please contact either the undersigned or Assistant District Counsel John A. Freeman, each of whom can be reached at extension 3211.

JAMES E. KAGY
Special Litigation Assistant

Attachments:
As stated.

cc: District Counsel, Cincinnati District
(with attachment)
cc: John A. Freeman, Assistant District Counsel
Cincinnati District (without attachment)
cc: Don Burkhart, ISP Utility Specialist
Akron, Ohio (with attachment)
cc: Pat Hallick, Appeals Office
Cleveland, Ohio (with attachment)

Internal Revenue Service

memorandum

CC:P&SI
Br1:DLRussell

date: OCT 28 1991

to: Assistant District Counsel
Cincinnati, Ohio
Attn: John Freeman

from: Senior Technician Reviewer, Branch 1
Office of Assistant Chief Counsel (P&SI)

subject: [redacted]

This responds to your request for informal written guidance concerning audit procedures of partnership items after enactment of section 402 of the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, 585-596. Two corporations, B and C, decided to form a partnership after investigating and implementing a certain business capability. Before formalizing the agreement, C paid $X in investigating and implementing expenses for the future benefit of the partnership and currently deducted these expenses under section 162 of the Internal Revenue Code. C transferred the business capability, which included the right of reimbursement of $Y from B, to D. D billed B for $Y, and in a separate transaction, B and D formed the partnership contemplated by B and C by contributing cash and other assets. The $X was never taken into account by the partnership, and B deducted $Y under section 162 in the year the partnership was formed. The partnership is subject to the audit procedures for partnerships enumerated under subchapter C of chapter 63 of subtitle F (the "TEFRA procedures").

The District Director proposes to disallow the deduction of $Y by asserting that it is a start-up expense of the partnership and, therefore, contributed by B to the partnership. See Madison Gas and Electric Co. v. Commissioner, 72 T.C. 521 (1979), aff'd, 633 F.2d 512 (7th Cir. 1980). B asserts that if the District Director wants to disallow the deduction of $Y, it must do so according to the TEFRA procedures at the partnership level. Accordingly, B asserts that the District Director cannot issue a statutory notice of deficiency disallowing the deduction of $Y. Instead, the Service must mail a notice of final partnership administrative adjustment (an "FPAA") to the tax matters partner (the "TMP") of the partnership proposing to increase the amount of B's contribution to the partnership. There is no mention of any other adjustments to B's income tax return.

You have asked whether an item you consider to be a partnership item and that was claimed as a deduction on a TEFRA partner's return (but not included on the partnership return) can be disallowed without commencing a partnership-level proceeding. Our response is based on the premise that the item in question is in fact a partnership item.

Section 6221 of the Code provides that except as otherwise provided in the TEFRA procedures, the tax treatment of any partnership item will be determined at the partnership level. Section 301.6221-1T of the temporary Procedure and Administration Regulations provides that a partner's treatment of partnership items on the partner's return may not be changed except as provided in sections 6222-6231 and the regulations thereunder. Thus, for example, if a partner treats an item on the partner's return consistently with the treatment of the item on the partnership return, the Internal Revenue Service generally cannot adjust the treatment of that item on the partner's return except through a partnership-level proceeding.

Under section 6222(a) of the Code, a partner must, on the partner's return, treat a partnership item in a manner that is consistent with the treatment of the partnership item on the partnership return.

Section 6222(b)(1) of the Code provides that section 6222(a) does not apply if (A) the partnership has filed a return but the partner's treatment on the partner's return is (or may be) inconsistent with the treatment of the item on the partnership return, and (B) the partner files with the Secretary a statement identifying the inconsistency.

Under section 6222(c) of the Code, if a partner does not comply with section 6222(a) or (b)(1)(B), section 6225 does not apply to any part of a deficiency attributable to any computational adjustment required to make the treatment of the items by the partner consistent with the treatment of the items on the partnership return.

Section 6225 of the Code provides that except as otherwise provided in subchapter C of chapter 63 of subtitle F, no assessment of a deficiency attributable to any partnership item may be made (and no levy or proceeding in any court for the collection of the deficiency may be made, begun, or prosecuted) before (1) the close of the 150th day after the day on which an FPAA was mailed to the TMP, and (2) if a proceeding is begun in the Tax Court under section 6226 during the 150-day period, the decision of the court in the proceeding has become final.

Under section 6225(b) of the Code, notwithstanding section 7421(a), any action that violates section 6225(a) may be enjoined in the proper court.

Under section 6231(a)(3) of the Code, "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of subtitle A, that item is more appropriately determined at the partnership level than at the partner level. Section 301.6231(a)(3)-1T(a)(1)(i) of the temporary regulations provides that partnership items include the partnership aggregate and each partner's share of items of income, gain, loss, deduction, or credit of the partnership.

Section 301.6231(a)(3)-1T(a)(4)(i) of the temporary regulations further provides that partnership items include contributions to the partnership, to the extent that a determination of this item can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner. Under section 301.6231(a)(3)-1T(c)(2), for purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine the amount of money contributed by a partner.

Section 6231(a)(6) of the Code defines "computational adjustment" as the change in the tax liability of a partner that properly reflects the treatment under the TEFRA procedures of a partnership item.

Assuming the $Y item is a partnership item, there are two alternatives available to the Service. Under the first alternative, the Service could make a computational adjustment that disallows the partnership item without mailing an FPAA to the TMP or to the partner. See section 6222(c) of the Code. By deducting the $Y item, B did not treat the $Y item in a manner that was consistent with the treatment of the item by the partnership. The computational adjustment would conform B's return to a position consistent with the treatment of the item as a partnership item.

It is possible that B may file a petition under section 6225(b) of the Code for an injunction against collection of the tax owed as a result of the computational adjustment. However, this position would require the taxpayer to assert that the $Y item is a partnership item subject to the TEFRA procedures when in fact the taxpayer did not treat the item as a partnership item. Because the $Y item was deducted by B but not by the

partnership, the court would likely enforce the Service's action under section 6222(c).

Once the Service makes a computational adjustment, B may make a timely request for an administrative adjustment under section 6227(a) and (c) of the Code. Thereafter, if appropriate, B may pay the tax and file a claim for refund pursuant to section 6228(b)(2). B may argue that the $Y item is not a partnership item in these proceedings. If the Court agrees that the $Y item is not a partnership item, then the Service must make the refund to B and, if possible, begin a deficiency proceeding under subchapter B of chapter 63 of subtitle F to assess a deficiency regarding the $Y item.

Under the second alternative, the Service could mail an FPAA to the TMP proposing to adjust the $Y item as an additional contribution received by the partnership. At the same time, a notice of deficiency under section 6213 of the Code could be mailed to B that disallows the $Y item because the item is a partnership item. If B timely petitions a proper court, the Service should file a motion to dismiss because the court lacks jurisdiction over partnership items. If the court agrees, the petition would be dismissed and the determination that the $Y item is a partnership item would be res judicata in the TEFRA proceeding. If the FPAA becomes final (or a court decision in favor of the Service becomes final), then a computational adjustment would be issued to B to conform B's return with the partnership's return.

Dianna K. Miosi

Dianna K. Miosi
Senior Technician
Reviewer, Branch 1
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)